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COVER STORY

Dealmakers get busy as banks exit mortgage loan servicing

Hugh Williams / Special to the Daily Journal

David H. Sands, a Los Angeles partner at Sheppard, Mullin, Richter & Hampton LLP, said there's a lot of activity in the market for mortgage loan servicing businesses right now.

By Andrew McIntyre / Daily Journal Staff Writer

United States banks are increasingly selling rights to service mortgages in response to the anticipated implementation of new capital requirements coming out of the Basel Committee on Banking Supervision, which means a flurry of activity for lawyers who work on the transactions and advise lenders on issues arising from the deals. Basel III, the latest standard from the international group of banking authorities, would require banks to set aside additional capital for mortgage servicing rights, a change to be implemented fully by no later than 2019, the committee says.

It's still unknown to what extent aspects of Basel III might affect U.S. banks, and the implementation deadline is six years down the road, but anticipation of change is causing banks to take action now. And rather than planning to increase capital on hand, banks are instead selling their mortgage servicing rights.

"Potentially, the Basel III regime could be a game changer in terms of who wants to hold these instruments," said Ellen R. Marshall, a Costa Mesa-based partner at Manatt, Phelps & Phillips LLP who has advised companies originating and servicing loans. "U.S. banks tend to have more MSRs on their books" than do foreign banks.

Mortgage servicing rights ostensibly entitle an institution either to select an outside servicer to collect monthly payments and handle other responsibilities or to service the loans directly. While banks often don't own home mortgages — many have sold their mortgages to Fannie Mae and Freddie Mac — banks have traditionally acted as servicers because mortgage owners often don't have the capacity to service loans.

Last week, Quicken Loans Inc. purchased the servicing rights to $34 billion in mortgages from Ally Bank for $280 million. And in January, Bank of America Corp. sold the rights to service 2 million of its loans to two different parties: Nationstar Mortgage Holdings Inc., which bought rights to service $215 billion in mortgages for $1.3 billion, and Newcastle Investment Corp., which forked out $519 million for rights to service $93 billion in mortgages.

"Ally is clearly trying to get out of involvement with mortgage," said Marshall, who has represented Ally Bank in the past. "I think it's not a bad play for private equity investors to buy MSRs."

Neither Ally nor Bank of America could be reached for comment.

"There's a lot of activity. And there's a lot of movement around the market in terms of who's looking at it and what their strategy is," said David H. Sands, a Los Angeles partner at Sheppard, Mullin, Richter & Hampton LLP who represents private equity firms and other buyers in mortgage servicing rights deals. "The biggest issue is it's really a new asset class. Banks need to ultimately deleverage that asset class in a manner such that they don't lose the customer relationship."

On top of Basel III's impact, rock-bottom interest rates and low housing prices have combined to create a "perfect storm" of buying and selling in the mortgage servicing rights space, Sands said. Banks are eager to get these assets off their balance sheets, and hedge funds "may be making a play based on where they think the market will move in the next six to 18 months," Marshall said.

Buyers of mortgage servicing rights are betting that the loans will remain outstanding for longer rather than shorter periods of time — essentially a bet that interest rates will go up and borrowers will not refinance, Marshall said.

And despite these purchases coming with a degree of risk, deal lawyers expect the buying and selling to continue.

"In the next six to 12 months, we're going to see a lot of activity as people start to pick their dance partners," Sands said. "Banks want a reliable source of capital. Private equity has an enormous pool of capital. This is an asset class into which you can put an enormous amount of capital."

But as mortgage servicing rights have begun to change hands more frequently, complaints from borrowers have become more common, too, said Michael S. Waldron, a Washington, D.C.-based partner at Ballard Spahr LLP. Waldron helps industry lenders prepare for and react to such complaints, which range from confusion over the new process when lenders have a new servicer to disputes about the actual amount of the mortgage owed.

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"It's often viewed as just a trade. In this environment, there's no such thing as just a trade," said Waldron. "Every trade, every deal, every move comes with regulatory impact and oversight, and I would say that that always needs to be part of the equation when assessing these trades."

All of the activity is, of course, welcome news to deal lawyers who work on mortgage servicing rights deals. While selling a portfolio of mortgage servicing rights is "not wildly different from buying a portfolio of other assets," as Marshall puts it, it's a fairly small group of law firms that do mortgage servicing rights transactions, said Sands.

"For the group of us who do this, I think it's going to be great," Sands said of the expected uptick in activity.

While the proposed 2019 final phase-in may seem far off, it's not stopping banks from acting now.

"It's not something you can start tomorrow and have it done in even six months or a year," Sands said. "It's something that's going to take a very long time. People don't want to wait until the end."

Waldron expects to continue to see plenty more mortgage servicing rights deals in the near future.

"I think on the transactional side," he said, "through this year and probably into what I'll call the foreseeable future, there will remain a high level of activity."